CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 357

March 14, 1973

DIVIDEND RECEIVED DEDUCTION: TAX ON ITEMS OF TAX PREFERENCE

Syllabus:

The amount of the items of tax preference on which a tax is imposed is not considered to be "income which has been included in the measure of taxes" for purposes of the dividend received deduction provided by Section 24402 of the Bank and Corporation Tax Law.

In 1971, Chapter 2.5 (Sections 23400-23403) was added to the Bank and Corporation Tax Law to impose a tax on "items of tax preference." The items specified in the statute relate to accelerated depreciation, bad debt allowances of banks and financial corporations, and percentage depletion. A tax is imposed at the rate of 2.5 percent.

A deduction for dividend income previously taxed by the state is provided by Section 24402 of the Bank and Corporation Tax Law, which reads as follows:

> Dividends received during the income year declared from income which has been included in the measure of the taxes imposed under Chapter 2 or Chapter 3 of this part upon the taxpayer declaring the dividends.

Pursuant to this section, the department makes a computation for multistate business taxpayers to determine the percentage of the dividend declared which is from income which has been included in the measure of the tax imposed under Chapter 2 or Chapter 3.

A question has arisen in the case of such multistate business taxpayers as to whether any dividend received deduction should be allowed on account of the tax paid by the declaring corporation on items of tax preference. The percentage of dividend declared that is deductible by recipients under Section 24402 is the percentage of the declaring corporation's total income that is included by the application of the apportionment formula in the measure of the California tax. In the case of the usual multistate taxpayer subject to unitary business income apportionment, the particular question that arises is whether the amount of the items of tax preference should be added to the income otherwise apportioned to California for purposes of the Chapter 2 or Chapter 3 taxes, i.e., the numerator of the fraction which determines the percentage of dividend that is deductible. The question similarly arises in several other situations where a multistate business taxpayer may have little or no apportionable business income, or may

have losses separately allocable to California which offset any apportioned income, and so pays only the minimum tax; for the same year, it may have large gains separately allocable to another state or it may have large amounts of dividend income allocable to another state, in which it is commercially domiciled, and it pays no California tax on such income. In any of these situations, it pays a minimum or no California tax, but it does have income from which it declares a dividend. At the same time, it may have items of tax preference, part of which are apportioned to California and on which a tax is imposed by the state. The question is whether any part of the dividend received by a California taxpayer should be deductible because the declaring corporation has paid a tax to California, and it may be contended that part of the dividend is deemed to have been declared from income taxed by California.

The specific question is whether the amount of the items of tax preference on which a tax is imposed is considered to be "income which has been included in the measure of taxes" for purpose of the dividend received deduction of Section 24402. It is concluded that it is not.

It is well settled that deductions are a matter of legislative grace and must be clearly authorized by statute. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 78 Law. Ed. 1348. The deduction for dividends received authorized by Section 24402 is limited to dividends which have been declared from income that has been included in the measure of the tax imposed under Chapter 2, the franchise tax, or Chapter 3, the corporation income tax. The tax on items of tax preference imposed under Chapter 2.5 is not mentioned in Section 24402. The section has been in effect in its present form for many years, and was not amended in 1971 at the time that the tax on preference items was enacted. Regardless of whether notions of mitigation of double taxation may tend to justify a dividend received deduction because of the tax on tax preference items, it can only be concluded that the required statutory basis for such a deduction is wholly lacking.

The language of Section 24402 is clear on its face, specifying only the Chapter 2 tax and the Chapter 3 tax but not the Chapter 2.5 tax. There is no ambiguity or uncertainty in the meaning of the language that warrants consideration of any intend different from that which is obvious from that language. Moreover, it maybe surmised that no dividend received deduction should be derived from the tax on preference items, because the preference tax is at the rate of 2.5 percent whereas the deduction for dividends received is claimed against income taxed at the much higher franchise and corporation income tax rates.